The Modernization Challenge Facing President Putin

Having established and strengthened basic market and democratic institutions during the 1990s, Russia became an emerging market country that badly needs a modernization breakthrough. How can the government of President Vladimir Putin attain this goal?

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THE URGE for modernization in Russia is stronger than in any other emerging market country. This former superpower lags further and further behind world leaders: Russia's GDP now ranks only fourteenth in the world, and its social indicators are close to those of medium-income developing countries.

When Vladimir Putin succeeded the elderly and ailing Boris Yeltsin as president, it was perceived as a symbolic change of epochs. Strong Russian political and cultural traditions are spurring Putin to bring Russia back into the group of the world's leading nations.

Putin begins his rule during a strong economic recovery that follows a fourfold devaluation of the ruble in 1998 and a sharp rise in world oil prices. Throughout 2000, macroeconomic and industrial indicators are likely to remain favorable, with GDP expected to rise by 4–5 percent if oil prices stay close to $30 a barrel.

In view of this good economic news, is achieving a modernization breakthrough really that important for Russia? The answer is definitely yes, because, during 2003–05, Russia may experience shortages of natural resources, and its efforts to boost economic growth may be hampered by the continued decay of its industries. The more an economic takeoff is delayed, the more difficult it will be for Russia to catch up with the advanced nations. Leading experts estimate that $2 trillion will be required in the next 20 years to modernize Russia's production facilities, infrastructure, and labor force. If modernization efforts begin today, it will take from 15 to 30 years for Russia to catch up with the West—and that is if the Russian economy grows at 6–8 percent annually.

Liberal-biased policy is likely

Strong public support allowed Putin to win the presidential election without having to articulate a detailed economic program. He made his stance clear, however, by repeatedly supporting "maximum economic freedom." He established the Center for Strategic Research (CSR), made up of pro-market scholars, and later astonished the public by appointing the ultraliberal Andrei Illarionov as his economic advisor and representative to the Group of Seven countries. (Some observers, however, regard this appointment as mere window dressing intended to ease negotiations with international financial organizations.)

Putin also endorses the Russian public's desire to see a "strengthening of the role of the state." He supports using the military-industrial complex as a locomotive of technological growth by raising government purchases from military companies by 150 percent over 1999. He has demonstrated his determination to bring down some of the omnipotent oligarchs and to fight corruption and crime. His government has submitted two bills to the parliament, one establishing state control over foreign exchange transactions and the other requiring registration of foreign trade transactions. The latter, if adopted, will give officials the power to suspend a transaction if there are good reasons to think it disguises capital flight or money laundering.

The lack of an official government program after six months' work by the CSR may reflect disagreements among ministers as to whether proposals in the CSR's policy paper are excessively radical and omit explicit support for domestic producers. A summary of this paper, which was leaked to the mass media, shows it indeed proposes a far-reaching liberal program aimed at modernization. It focuses on eliminating exchange and trade restrictions, creating a favorable investment climate, deregulating the economy, providing guarantees for ownership of private property, and fostering competition. Speaking at the Moscow branch of the Carnegie Foundation for International Peace, the head of the CSR and minister for economic development, German Gref, emphasized a revolutionary idea: securing the independence of courts by electing judges for life terms, he said, is crucial to Russia's efforts to achieve economic success.

But one should also bear in mind that Russia's real economic course is strongly influenced by businesspeople who are accustomed to lobbying, corruption, and paternalism. Influential industrial groups want the government to protect them from rival foreign investments by allowing only selected "friendly" companies to operate in Russia (the stance labeled "hammerization" after U.S. oil tycoon Armand Hammer's strategy of relying on his friendships with Kremlin leaders to make business deals in the former Soviet Union). So Putin's policy must be pragmatic in responding to various challenges and vested interests. Nonetheless, it is likely, though not inevitable, that his economic policy will have a liberal bias, because the government currently controls a very small share of the national economy. Federal budget revenues in 1999 were only about 14 percent of GDP, and those of all levels of government combined were only 36 percent of GDP. Existing government financial and economic institutions lack the power and the resources to intervene effectively in the Russian economy, so it will be difficult for the government to be an active player in Russian markets in the years to come.

The first few months of Putin's rule show that he is quite serious about the comprehensive modernization of Russia. If he continues to pursue this objective, his economic achievements will depend on progress being made in four areas: bringing down foreign debt, creating a market-friendly environment, restructuring the real sector, and bringing order to economic federalism.

Pressure of foreign indebtedness

Foreign indebtedness will continue to exert strong pressure on Russia's economic performance. Russia's foreign debt is now about $160 billion and, during 2001–05, annual repayments will amount to between $12 billion and $17 billion—more than half the federal budget.

Currently, the economic outlook for Russia is promising because of a budgetary surplus, foreign exchange earnings from high world prices for fuel and raw materials, and capital inflows. By May 2000, Russia was servicing and repaying its debts as scheduled. But, as the old Russian saying goes, "good luck never lasts long."

Why is Russia likely to run into economic difficulties before long? First, fuel prices are so high that importers are beginning to reduce demand and are thus pushing prices down. Second, the ruble will appreciate as capital continues to flow in and domestic demand for foreign machinery and equipment—to offset the decay of domestic production facilities—increases sharply. If this happens, Russia's balance of payments will deteriorate and it will have serious problems repaying its foreign debt.

Large-scale Russian indebtedness brings about a vicious circle: resources are "pumped out" of the country, thereby hampering technological development that might help Russia earn the foreign exchange it needs to cope with indebtedness. In this respect, Russia's position resembles that of Latin America in the early 1980s. But Russia is not prone to volatile governments, hyperinflation, and economic populism. Putin's rule is going to be fairly authoritarian, and debts can be repaid if the country forgoes other expenditures.

Structural reform is the only true solution to Russia's foreign indebtedness problem. When it must choose between structural reforms and improving the social safety net, the government will definitely pursue the former. This approach need not necessarily lead, however, to dramatic reductions in living standards for lower-income groups if the available social funds are spent in a more rational way and competitive private enterprises become involved, along with governments, in providing social and public services.

There is also considerable room for better management of Russian foreign debt (for example, by undertaking debt/equity and other swap operations). But improving relations with the West will be decisive in bringing down foreign indebtedness. Currently, relations seem to have improved, raising hopes that the West will restructure Russia's old debts. If it does, no less than 70 percent of the $100 billion in Soviet debt should be restructured to preserve socially tolerable levels of public spending. The former minister of the economy, Yevgeniy Yasin, proposed a more radical position, arguing that Russia will achieve sustained growth only if all Soviet debt is written off and current debt payments are restructured. Furthermore, provision must be made for preferential repayment terms for the first 10 years and an overall repayment period of not less than 30 years; major debt payments must be rescheduled beyond 2005, giving the economy several years to restructure and take off.

Improving the economic environment

Everybody who does business in Russia knows that problematic laws and weak legal enforcement, corruption, high taxes, and mafia (organized criminal) activity make it an ordeal. Improving the financial and legal environment must be high on Putin's agenda, because Russia's economic revival must rely almost exclusively on private investment.

What hamper business in Russia most of all are taxes. If entrepreneurs paid all the taxes they owed, they would pay more than they earned. Therefore the "shadow economy" amounts to about 25 percent of GDP. Tax evasion is one of the main reasons—along with control of mediators over resource and output flows, schemes designed for managers' personal benefit, and the high price of money—behind the wide use of money surrogates (for example, promissory notes—*veksel*) and barter.

Over the years, there has been much talk in Russia about reducing the tax burden, but only Putin's government has tackled the issue. It intends to improve the general rules of the game for taxation and lower taxes on producers and ordinary citizens. Tax officials plan to eliminate all preferences and seek to establish equal conditions for all. This approach signals a radical shift in the government's economic philosophy. The government seems to understand the significance of improving the economic environment. Legal experts are working on protecting minority stockholders' interests, introducing transparent accounting techniques, and implementing other reform measures. But carrying out some important reforms requires consistent policy rather than isolated initiatives.

First, Russia must support competition. Russia is not yet a truly open and competitive economy because of high barriers to entry for investors. The government must establish simple and uniform terms for establishing new companies and put an end to the arbitrary rule of regional officials as well as to criminal pressures on businesses. Second, the role of markets must be substantially enhanced. Introducing private ownership of land will benefit the agrarian sector and also bolster financial markets, because land could serve as collateral for mortgages. No less important is enacting more flexible policies for wages and working conditions in the private sector. Third, a reform of the judicial system like that mentioned by German Gref is badly needed to ensure that independent courts can enforce contracts (replacing criminal groups as enforcers) and resist pressure from high-ranking officials.

Problems in the real sector

In the first quarter of 2000, Russia's real sector grew at a rate 12 percent higher than in the corresponding period of 1999. But the government's failure to establish and enforce clear property rights will undermine further expansion. In the language of economist Ronald Coase, this means that Russian owners must enjoy full power over their assets and the profits they earn by using them. But now privatization has halted, and businesspeople look forward to the government's beginning to sell shares in state-owned firms to the public. Meanwhile, current owners are consolidating their stockholdings to gain full control over their companies.

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Under former president Yeltsin, the government refrained from restructuring companies to avoid the inevitable increases in unemployment and allowed companies to exercise "adjustment without restructuring." Paradoxically, Russia's bankruptcy law is applied to viable companies when someone wants to buy them cheap, and not to the insolvent ones, in which no one is interested.

Putin will need to force companies to undertake "adjustment *with* restructuring." Companies should be pressed to separate into viable and nonviable divisions and to sell off the latter, thereby reducing overemployment. By now, companies have stopped providing social safety nets for their workers, but many of their viable divisions badly need modernization: Russian industrial equipment has been used for an average of 16 years and has depreciated to only 30 percent of its original value. The government has been unable to finance modernization (companies have enjoyed tacit subsidies, however, because the government did not press them to pay their taxes), so companies must rely primarily on their own resources and private loans. The government might assist their modernization efforts, though, by attracting foreign banks to Russia, thereby lowering interest rates on loans.

The government must help companies get rid of arrears that arose from a discrepancy between a restrictive macroeconomic policy and a soft microeconomic policy that has tolerated tax arrears and interenterprise debts, and from the government's failure to meet its commitments. The first step should be arranging mutual settlements between companies. But this must be followed by development and implementation of a consistent policy of gradually strengthening budget constraints on various types of settlements, including payments for energy supplies, interenterprise payments, and tax payments.

Regional dimension of economic reforms

During 1996–97, regional governors were freely elected and subsequently became fairly independent of the Kremlin. This added to existing tensions created by discrepancies between federal and regional laws, economic privileges granted by the Kremlin in response to pressure from oil-producing ethnic republics, and disputes between Moscow and the regions over tax-revenue sharing and property rights in productive facilities.

The government set up a system to redistribute money through Moscow to support poorer regions. Although net redistribution accounts for only 1 percent of GDP, it arouses considerable conflict. There are only 10 "donor" regions—that is, regions that contribute more to the federal budget than they receive from it—and they are unhappy that their payments make up more than half the federal budget. Some regions pursue policies of "glocalization" by establishing direct links with foreign partners, which often makes them more dependent on international markets than on decrees signed in Moscow.

Russia's finances currently are chaotic. Putin and his team have repeatedly emphasized the need for a stronger vertical line of state administration, and, shortly after his inauguration, Putin issued a decree to unite Russia's 89 regions into 7 federal districts headed by his representatives. This move may eliminate tax splitting among different levels of government, reduce financial redistribution, and, most important, stop the misuse of resources and facilities by regions. Presidential representatives are likely to distribute federal transfers in accordance with the behavior of regional leaders. If this plan works, Russia may substantially improve tax collection and management of public property. However, Putin's success is not certain, because the governors tacitly but stubbornly resist the plan.

Will Putin succeed in modernizing Russia?

Although Putin's era is just beginning, it is possible to make some predictions.

Putin has already shown himself to be a resolute and efficient leader. The economic problems he faces are very serious, however. It will be difficult to deliver Russia quickly from foreign indebtedness. Debts will press on the economy throughout Putin's rule, although the government can ease this burden somewhat if it comes to an agreement with creditors. In any case, paying Russia's debts may entail austerity measures, and living standards are not going to improve. The money flowing into the country now, following political and financial stabilization, will be spent on technological modernization.

But prospects in other economic fields are less gloomy. Putin has sufficient power to carry out badly needed reforms. Much depends on whether he will persist in seeking profound changes in economic institutions despite the reluctance of Russian businesspeople to adjust to a liberal economy and competitive markets.

Still, if a pro-market policy is pursued, Russia can enjoy sustained growth. The most plausible economic growth projections based on this assumption, calculated by the CSR, are in the range of 5–6 percent a year for the next 10 years. This rate would not be enough to bring about a substantial improvement in Russia's international positions, because the world economy is expected to grow at almost the same rate. Even if a pro-market strategy is pursued, Russia will not be able to meet the modernization challenge. Putin's rule will therefore be judged a success if, during it, Russia begins to achieve a modernization breakthrough. F&D

Suggestions for further reading (in Russian):

L. Abalkin (ed.), 1999, Russia–2015: An Optimistic Scenario *(Moscow: IERAN).*

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